

**DEPARTMENT OF STATE REVENUE**  
**LETTER OF FINDINGS NUMBER: 05-0175**  
**Adjusted Gross Income Tax**  
**For the Year 1998-2001**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Adjusted Gross Income Tax--Unitary Filing**

**Authority:** Ind. Code § 6-3-2-2; Ind. Code § 6-3-2-2.4; I.R.C. § 243

Taxpayer protests the forced combination of it and seven subsidiaries.

**II. Adjusted Gross Income Tax—Apportionment Factors**

**Authority:** 45 IAC 3.1-1-51, 45 IAC 3.1-1-52, 45 IAC 3.1-1-153

Taxpayer protests the elimination of sales between a partnership and a corporation that were included on a unitary tax return, when the corporation to whom the partnership's sales were made did not directly own any interest in the partnership.

**III. Tax Administration--Application of payments**

**Authority:** Ind. Code § 6-8.1-3-17; Ind. Code § 6-8.1-8-1.5

Taxpayer made a payment under amnesty but did not withdraw its protest of tax due.

**IV. Tax Administration--Negligence Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the assessment of a negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is the parent corporation of a group of companies that manufacture and sell various electronic transaction systems. On a separate company basis, Taxpayer is the only company that has any Indiana payroll, property or sales.

During 1999, Taxpayer divided its manufacturing operations into two subsidiaries, Sub M and Sub S, which handled the manufacturing of Taxpayer's systems. After the division, Sub S manufactured the systems in question and transferred the systems to Sub M. Finished goods were transferred from Sub M to Sub P, a partnership. Sub P, which was owned partly by Sub H and Sub SH, owned all intangible relating to the manufacturing and marketing process. Sub P in turn transfers the property to Taxpayer.

In addition, three other subsidiaries, Sub F, Sub IC, and Sub IM manage Taxpayer's financial assets. During the years in question, Taxpayer filed a separate Indiana return. However, a Department audit concluded that Taxpayer and various subsidiaries should have filed a unitary return. As a result, the Department assessed additional tax, interest and a negligence penalty. Taxpayer filed a protest, and a hearing was held.

Taxpayer was assessed roughly \$550,000 of additional tax as a result of the assessment, including the assessment of taxes that had been previously refunded. During Indiana Tax Amnesty, Taxpayer paid approximately \$82,000 of tax that it conceded was properly assessed. However, Taxpayer maintained its right to protest notwithstanding the payment and did not otherwise reach a settlement agreement during the amnesty period.

**I. Adjusted Gross Income Tax--Unitary Filing**

**DISCUSSION**

First, Taxpayer protests the assessment with respect to several manufacturing subsidiaries. Taxpayer concedes that it and the manufacturing subsidiaries were unitary; however, Taxpayer maintains that the Department must show a failure to fairly reflect income from Indiana sources under the methods provided under Ind. Code § 6-3-2-2(1) prior to an attempt to force unitary filing; in effect, forced unitary filing is a last resort. Taxpayer argues that its deductions for payments between entities were determined on an arms-length basis. Taxpayer has conceded that certain payments were not made in accordance with the agreement and conceded at least that portion of the liability.

Taxpayer, as a separate entity and as the company associated with its machines, lost roughly \$25,000,000 during the four years in question, without any decrease in its sales to third parties; however, the group of companies had income \$500,000,000. The group as a whole had over \$1,000,000,000 of payroll and \$2,000,000,000 over the period. Taxpayer had roughly 80 percent of the overall property and 90 percent of the payroll of the entire group for the years in question; Sub M and Sub S had virtually the entire balance of property, while the other entities had a combined \$1,000 of property and \$6,100 of payroll for the entire period. The only sales by entities other than Taxpayer consisted of sales within Taxpayer's chain of companies, or passive or "other" income. Here, based on the individual return versus the return for the entire entity, Taxpayer sought to shield virtually all of the income of the entire entity from the scope of Indiana's taxation. This represents a failure to fairly reflect all income of Taxpayer's unitary business. Taxpayer's Indiana income is not that of an isolated entity, with various other entities; it is the income of the entire entity, each an interrelated part of Taxpayer.

Other remedial measures are available to the Department, such as the disallowance of deductions between entities or other methods. The use of these methods depends on the facts and circumstances of each individual case. In this case, Taxpayer seeks to add back deductions claimed pursuant to a transfer-pricing study for expenses between Taxpayer and its miscellaneous subsidiaries. Sub S incurred \$6,000 in costs to manufacture a machine. Sub M bought the machine for \$7,000, and added a few improvements. Sub P paid \$8,000 for the finished machine. Taxpayer paid \$9,000 for the machine, and sold the machine for \$10,000. Here, the net effect of manufacturing a machine and receiving a \$4,000 profit became one of Taxpayer, Sub S, Sub M and Sub P all getting \$1,000 profit. Sub P's profit was further divided between two entities, each of which had zero property, payroll, or sales (other than passive or "other" income) as independent entities. Effectively, this left \$1,000 subject to taxation, rather than the \$4,000 that Taxpayer actually realized from the transaction.

The relationship between Sub F, Sub IC, Sub IM and Taxpayer works like this:

Taxpayer enters into a sale on credit, resulting in a receivable.

Sub F purchases the receivable at face value, plus a factoring commission equal to prime rate plus three percent.

Sub F then seeks to collect on the receivable. If a portion of the receivable is not collected by the expected maturity date, Taxpayer repurchases the receivables at face value less payments and expenses incurred by Sub F

Sub IC owns Sub F. Sub IC manages Taxpayer's intangible assets and distributes income from those investments. Any administrative functions are performed by Taxpayer's employees, with expenses paid by Sub IM.

Sub IM performs management functions for Sub IC and Sub F. These functions are actually performed by Taxpayer's employees, with expenses paid by Sub IM.

For instance, a customer incurred a \$10,000 receivable with Taxpayer, payable at 10.5 percent annual interest over three years. Prime rate was 7.5 percent. As a result, Taxpayer sold the receivable to Sub F for \$11,050. In order to retire the debt, payments of \$323 were made for the duration of the receivable. This resulted in a profit of \$1,628 on the transaction. Of this, only \$1,050 was realized by Taxpayer. The other \$578 was realized by Sub F.

However, if the customer failed to make the first payment on the agreement, Sub F would then sell the receivable back to Taxpayer at the end of three years for \$424 (the face value of the loan), plus expenses of Sub F. Sub F realized a gain of at least \$679 (\$255 collected above its \$11,050 purchase price of the receivable, and \$424 of face value). Taxpayer then collects the \$424. Taxpayer's gain was only \$1,050. In effect, Taxpayer was able to realize a fixed gain from every sale, and any excess income on receivables was siphoned to Sub F. If the debt becomes uncollectible, Sub F's losses were limited to its "factoring commission" (i.e., \$1,050 in the example given), while Taxpayer still retained much of the benefit of any losses. In sum, Taxpayer and Sub F engaged in a transaction that resulted in little more than a shifting of income

from Taxpayer to Sub F. Further, the only way to take into account the value of the receivable to Taxpayer is to combine the entities; any other approach serves to permit arbitrary shifting of income illustrated by the example provided.

With respect to Sub IC and Sub IM, these companies were little more than paper entities. The only difference is that the income was insulated into entities without any real substance or tax liability (per the Department's audit report) and permitting Taxpayer to reduce its income artificially. The recipient company (Sub IC or Sub IM) was then able to draw interest and/or third-party dividends on the segregated income, which could then never be touched by Indiana on a separate company basis. Further, when the recipient paid dividends back to Taxpayer for the day-to-day use in Taxpayer's business, Taxpayer would be able to claim a full deduction of the dividends under I.R.C. § 243(b)(1) and thus never be taxed. Other approaches that could be taken to account for Taxpayer's income simply do not take into account the income earned for Taxpayer's operations by Sub IC and Sub IM.

In short, the remedial steps under Ind. Code § 6-3-2-2(l) other than forced combination do not fully account for Taxpayer's income from its overall operations. In this particular instance, the combination of legally separate but functionally interdependent identities--a unitary return--is the appropriate remedy.

Taxpayer also protests the inclusion of certain entities in Taxpayer's unitary group. Taxpayer asserts that a laundry list of other companies should have been included on the unitary return, rather than the entities that the Department determined to be part of the return.

This argument has two problems. One, Taxpayer has not provided any information concerning whether the entities were unitary or how the inclusion of various entities would more fairly reflect its Indiana income than the Department's method. Second, a number of the entities appear to be foreign corporations or foreign operating corporations as determined under Ind. Code § 6-3-2-2.4. Taxpayer can make an election to include those entities if it files a request to include those entities with the Department no more than thirty (30) days after the close of Taxpayer's taxable year. Ind. Code § 6-3-2-2(q). Taxpayer did not do this. Under Ind. Code § 6-3-2-2(o), the Department is precluded from requiring inclusion of the foreign corporations or foreign operating corporations. Accordingly, Taxpayer's protest is denied.

### **FINDING**

Taxpayer's protest is denied.

## **II. Adjusted Gross Income Tax—Apportionment Factors**

### **DISCUSSION**

Taxpayer further argues that, if Taxpayer was required to file a combined return with its various subsidiaries, the Department erroneously eliminated sales between Taxpayer and Sub P. Taxpayer argues that only the sales between a unitary partnership and its corporate partners

should be eliminated; therefore, only the sales between Sub P and Sub P's partners, Sub H and Sub SH, should be eliminated.

Taxpayer cites to 45 IAC 3.1-1-153(b)(2), which states:

Intercompany sales between the corporate partner and the partnership shall be eliminated from the corporate partner's sales factor as follows:

(A) Sales by the corporate partner to the partnership to the extent of the corporate partner's interest in the partnership.

(B) Sales by the partnership to the corporate partner not to exceed the corporate partner's interest in all partnership sales.

While 45 IAC 3.1-1-51 and -52 provide for elimination of sales between members of an affiliated group filing consolidated returns, both the statutes and regulations are silent in terms of members of a unitary group that are not partners in a corporate partnership. That stated, the logic behind the elimination of sales between affiliated companies—double counting of the same sale on the return of the same taxpayer (via combination)—is exactly the same in this case. Thus, notwithstanding the language of 45 IAC 3.1-1-153 dealing with corporate partners, the elimination of sales between Taxpayer and Sub P was proper.

### **FINDING**

Taxpayer's protest is denied.

### **III. Tax Administration—Application of payments**

#### **DISCUSSION**

Taxpayer also presented a situation that arose after the Department's administrative hearing. Taxpayer had a net assessment of roughly \$550,000 of base tax. However, Taxpayer's position was that it owed only a base tax of \$82,000. Prior to the November 15, 2005, expiration of the amnesty period under Ind. Code § 6-8.1-3-17(c), Taxpayer paid \$82,000; however, Taxpayer did not withdraw its protest of the tax due.

Under the provisions of Indiana Tax Amnesty, taxpayers were given the opportunity to pay their base tax liability as determined by the Department without any penalties or interest that may have been otherwise due. In exchange for the payment, the taxpayers agreed to withdraw and/or forego any rights to refunds, appeals, or administrative protests for the taxes paid.

Even if Taxpayer's position on unitary filing is sustained, Taxpayer's payment cannot be considered a payment subject to the special provisions of the amnesty program because Taxpayer did not waive its continued protest. Accordingly, the payment should be applied in the normal manner under Ind. Code § 6-8.1-8-1.5, without any waiver of penalties and/or interest provided under amnesty.

### **FINDING**

Taxpayer's protest is denied.

#### **IV. Tax Administration--Negligence Penalty**

### **DISCUSSION**

The Department may impose a ten percent negligence penalty. Ind. Code 6-8.1-10-2.1 and 45 IAC 15-11-2. Taxpayer's failure to pay taxes as determined by Department audit will result in a negligence penalty. Ind. Code 6-8.1-10-2.1(a)(3). The Department, however, may waive this penalty if the taxpayer can establish that its failure to file "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...." *Id.*

With respect to the penalty, Taxpayer has not provided sufficient information to permit penalty waiver.

### **FINDING**

Taxpayer's protest is denied.

JR/JM/DK 062402